

# **Arizona State Retirement System**

## **Total Fund Review and Investment Outlook**

### **For the Period Ended September 30, 2010**

December 17, 2010

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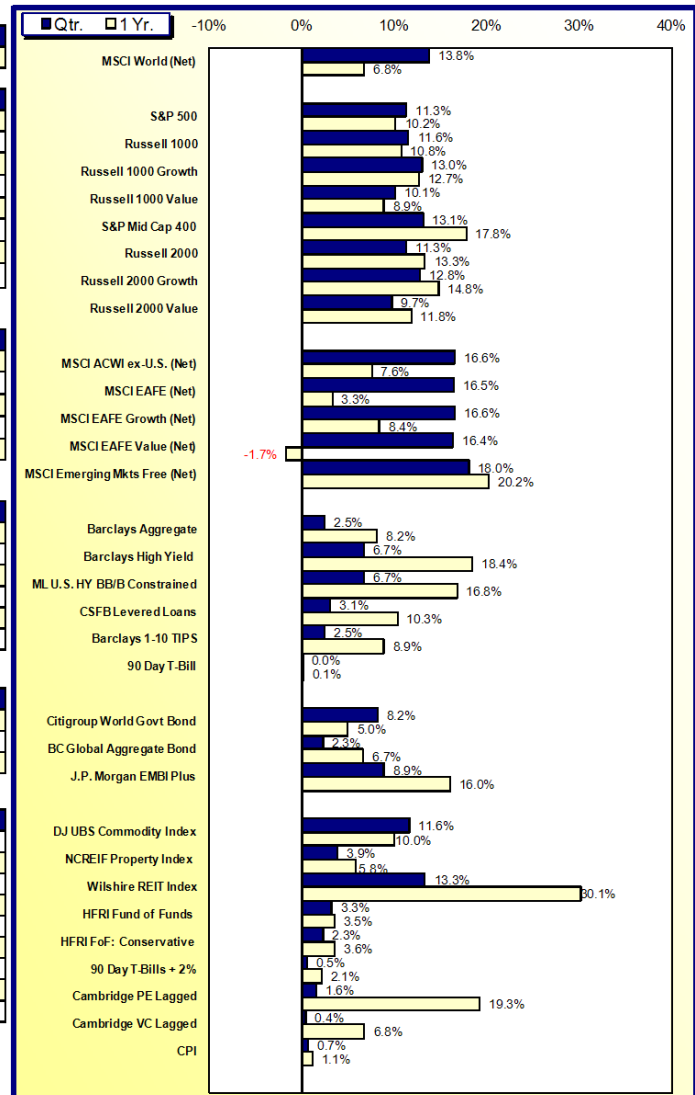
NEPC, LLC

# Market Environment

**Note: All of the data in this report is as of September 30, 2010, unless otherwise noted.**

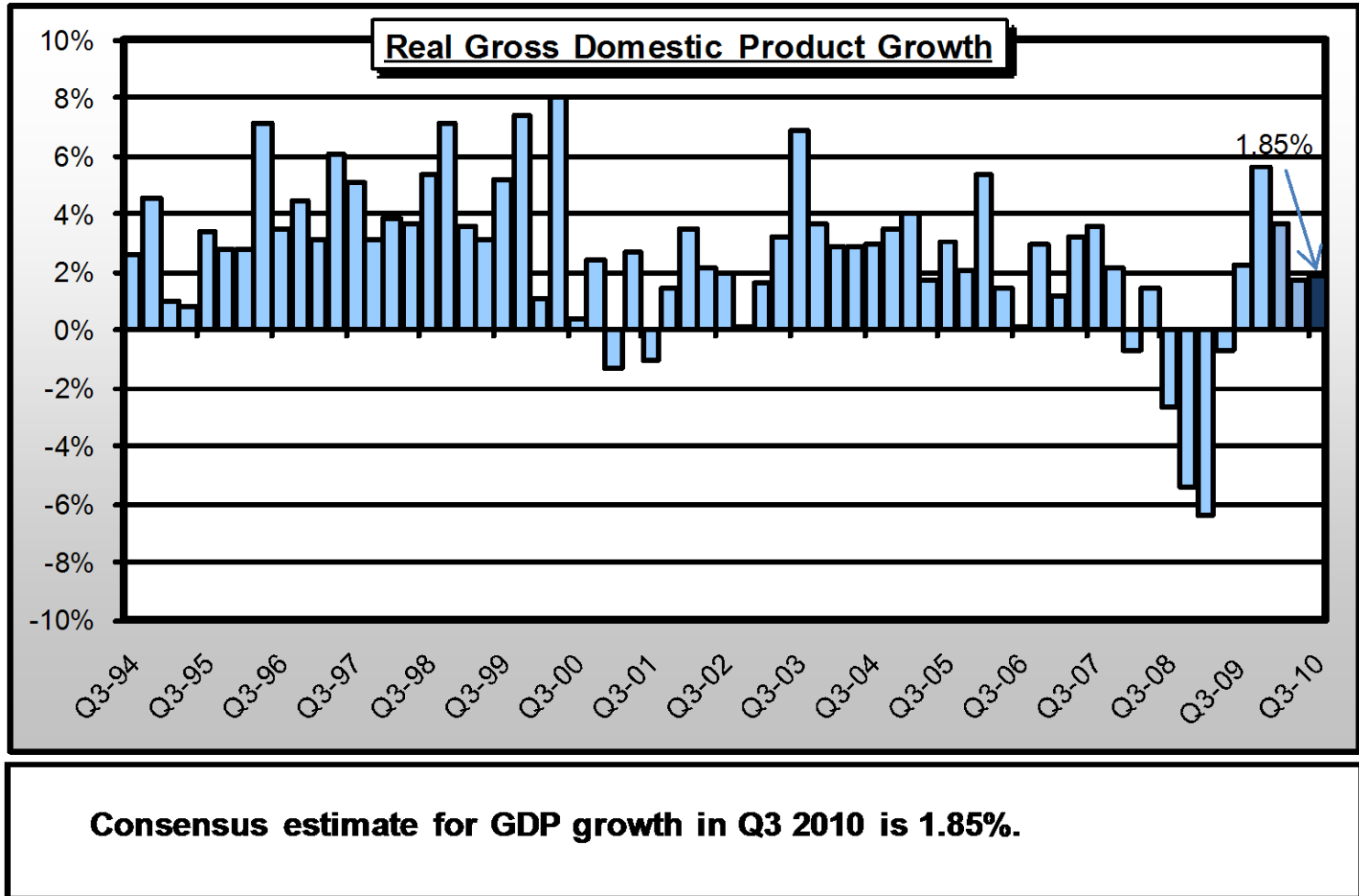
# Market Environment – Overview

		Qtr.	YTD	1 Yr.	3 Yr.	5 Yr.	10 Yr.
<b>Global Equity Benchmarks</b>							
MSCI World (Net)	World	13.8%	2.6%	6.8%	-8.3%	1.3%	0.8%
<b>Domestic Equity Benchmarks</b>							
S&P 500	Large Core	11.3%	3.9%	10.2%	-7.2%	0.6%	-0.4%
Russell 1000	Large Core	11.6%	4.4%	10.8%	-6.8%	0.9%	-0.2%
Russell 1000 Growth	Large Growth	13.0%	4.4%	12.7%	-4.4%	2.1%	-3.4%
Russell 1000 Value	Large Value	10.1%	4.5%	8.9%	-9.4%	-0.5%	2.6%
S&P Mid Cap 400	Mid Core	13.1%	11.6%	17.8%	-1.7%	3.8%	5.4%
Russell 2000	Small Core	11.3%	9.1%	13.3%	-4.3%	1.6%	4.0%
Russell 2000 Growth	Small Growth	12.8%	10.2%	14.8%	-3.8%	2.4%	-0.1%
Russell 2000 Value	Small Value	9.7%	7.9%	11.8%	-5.0%	0.7%	7.7%
<b>International Equity Benchmarks</b>							
MSCI ACWI ex-U.S. (Net)	International	16.6%	3.7%	7.6%	-7.4%	4.3%	4.3%
MSCI EAFE (Net)	Int'l Developed	16.5%	1.1%	3.3%	-9.5%	2.0%	2.6%
MSCI EAFE Growth (Net)	Int'l Developed	16.6%	4.1%	8.4%	-8.4%	2.8%	1.1%
MSCI EAFE Value (Net)	Int'l Developed	16.4%	-1.9%	-1.7%	-10.7%	1.1%	3.9%
MSCI Emerging Mkts Free (Net)	Int'l Emerging	18.0%	10.8%	20.2%	-1.5%	12.7%	13.4%
<b>Domestic Fixed Income Benchmarks</b>							
Barclays Aggregate	Core Bonds	2.5%	7.9%	8.2%	7.4%	6.2%	6.4%
Barclays High Yield	High Yield	6.7%	11.5%	18.4%	8.8%	8.4%	8.0%
ML U.S. HY BB/B Constrained	High Yield	6.7%	11.6%	16.8%	7.6%	7.3%	7.3%
CSFB Levered Loans	Bank Loans	3.1%	6.5%	10.3%	3.2%	4.0%	n/a
Barclays 1-10 TIPS	Inflation-Linked	2.5%	7.0%	8.9%	6.9%	5.5%	7.5%
90 Day T-Bill	Cash	0.0%	0.1%	0.1%	1.1%	2.6%	2.6%
<b>Global Fixed Income Benchmarks</b>							
Citigroup World Govt Bond	Global Bonds	8.2%	7.1%	5.0%	8.2%	7.1%	7.6%
BC Global Aggregate Bond	Global Bonds	2.3%	6.3%	6.7%	6.4%	5.3%	5.8%
J.P. Morgan EMBI Plus	Em. Mkt. Bonds	8.9%	14.5%	16.0%	10.2%	9.4%	11.0%
<b>Alternative Benchmarks</b>							
DJ UBS Commodity Index	Commodities	11.6%	0.9%	10.0%	-6.8%	-2.3%	5.2%
NCREIF Property Index	Real Estate	3.9%	8.1%	5.8%	-4.6%	3.7%	7.2%
Wilshire REIT Index	REIT	13.3%	19.2%	30.1%	-6.9%	1.4%	10.1%
HFRI Fund of Funds	Hedge Funds	3.3%	2.0%	3.5%	-3.0%	2.2%	3.7%
HFRI FoF: Conservative	Hedge Funds	2.3%	2.5%	3.6%	-3.0%	1.4%	3.3%
90 Day T-Bills + 2%	Hedge Funds	0.5%	1.6%	2.1%	3.1%	4.6%	4.6%
Cambridge PE Lagged	Private Equity	1.6%	12.3%	19.3%	-0.9%	10.4%	7.8%
Cambridge VC Lagged	Venture Capital	0.4%	4.4%	6.8%	-2.5%	5.1%	-5.9%
CPI	Inflation	0.7%	0.5%	1.1%	1.6%	1.9%	2.3%

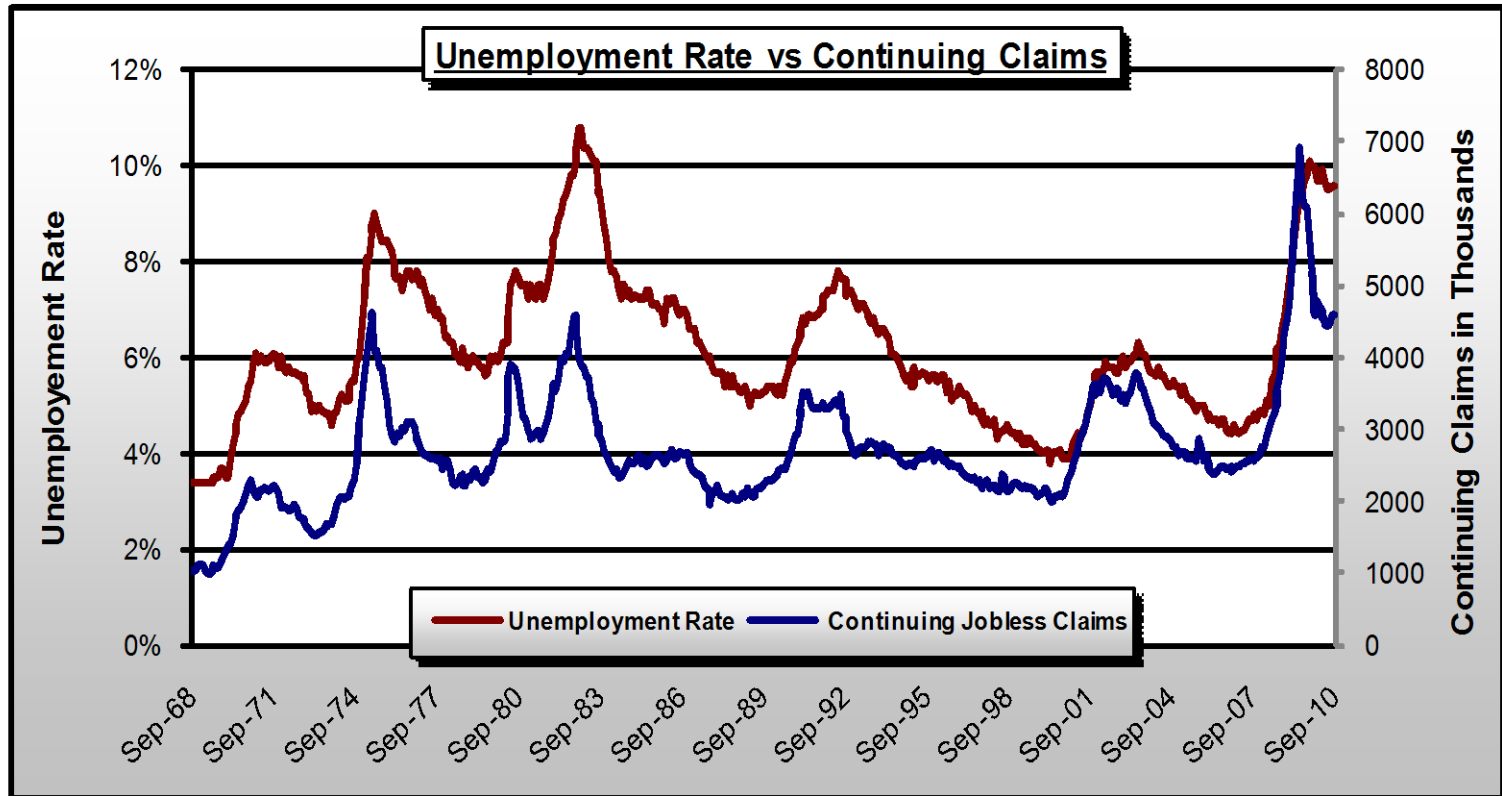


Note: Cambridge Private Equity and Venture Capital Indexes are lagged by one quarter. Performance shown as of June 30, 2010.

# Market Environment – U.S. Economy

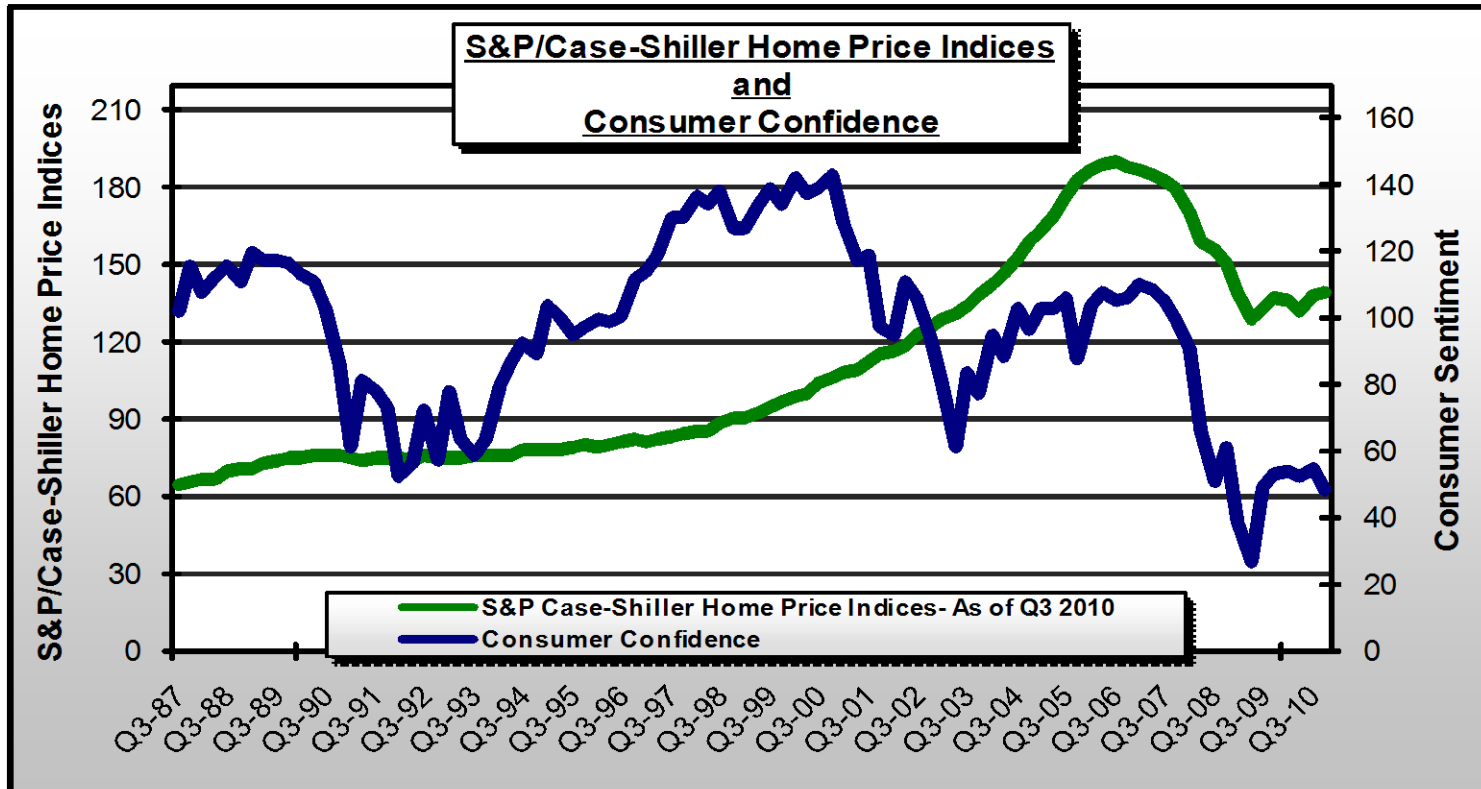


# Market Environment – U.S. Economy



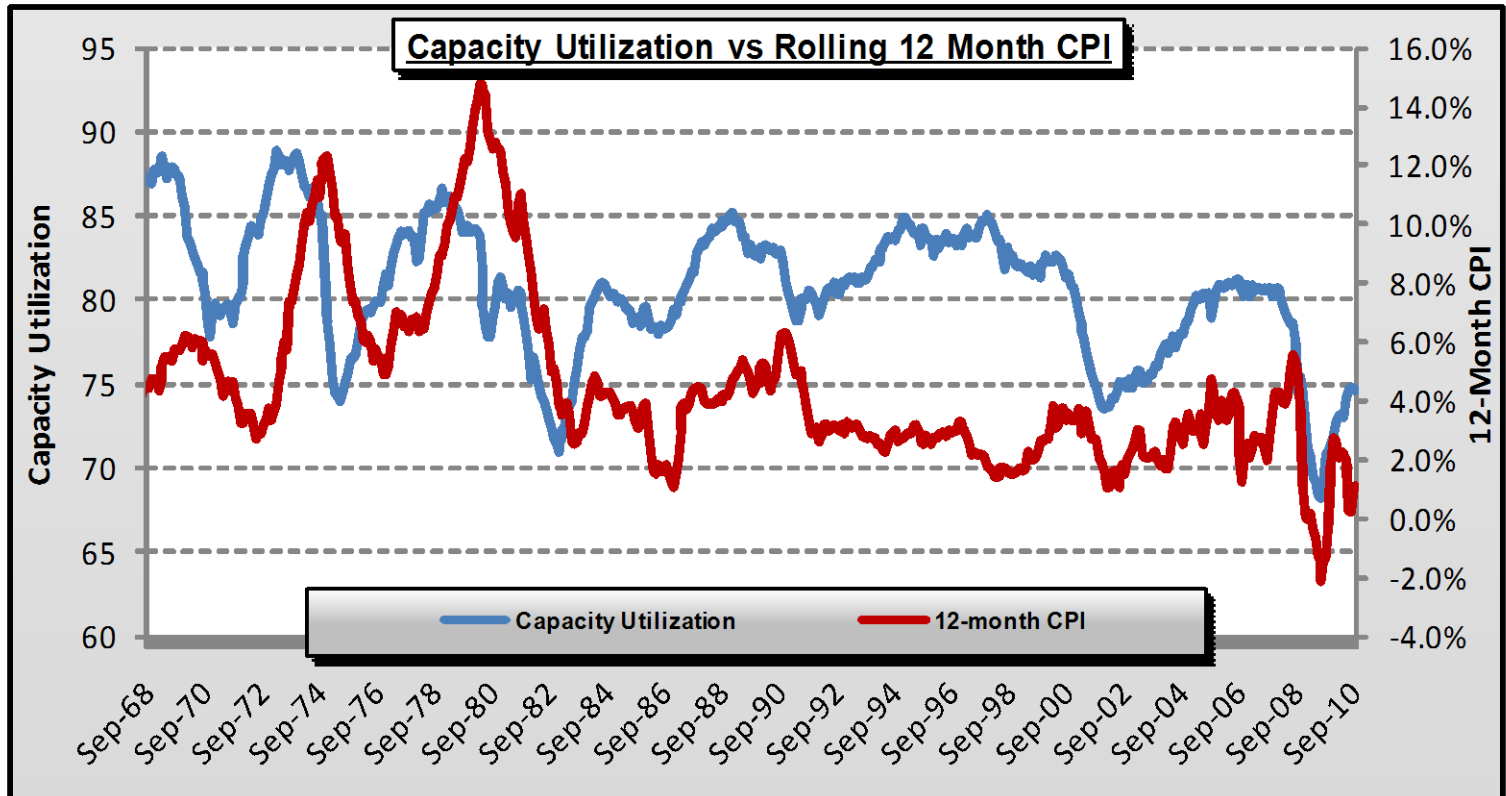
**Unemployment has remained relatively flat in 2010, increasing modestly to 9.6% in the third quarter, despite a significant drop in continuing claims.**

# Market Environment – U.S. Economy



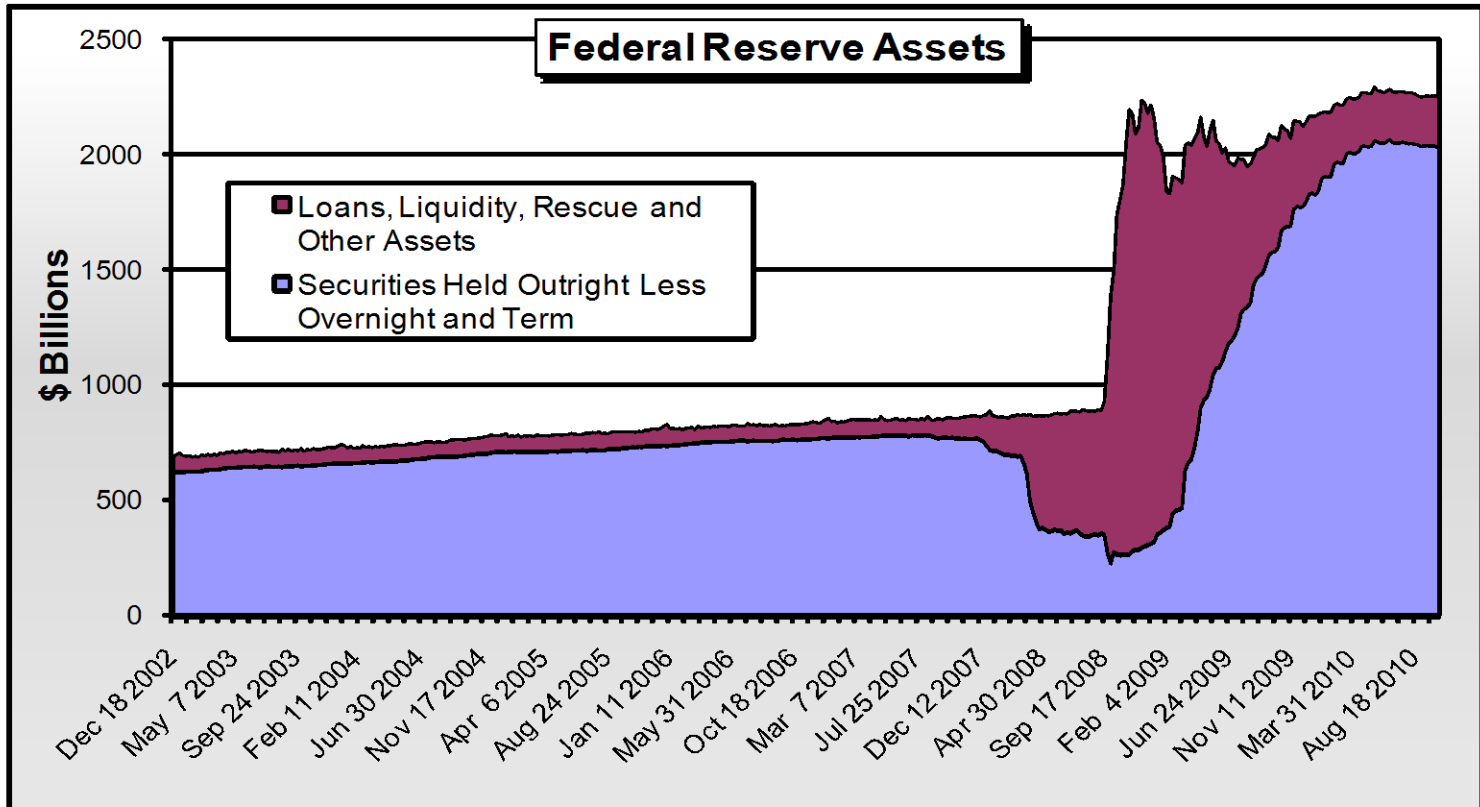
**Housing prices rose modestly in Q3 while Consumer Confidence declined after moving sideways earlier in 2010.**

# Market Environment – U.S. Economy



**Capacity utilization has recovered sharply but still remains at depressed levels while CPI has settled at 1.1%.**

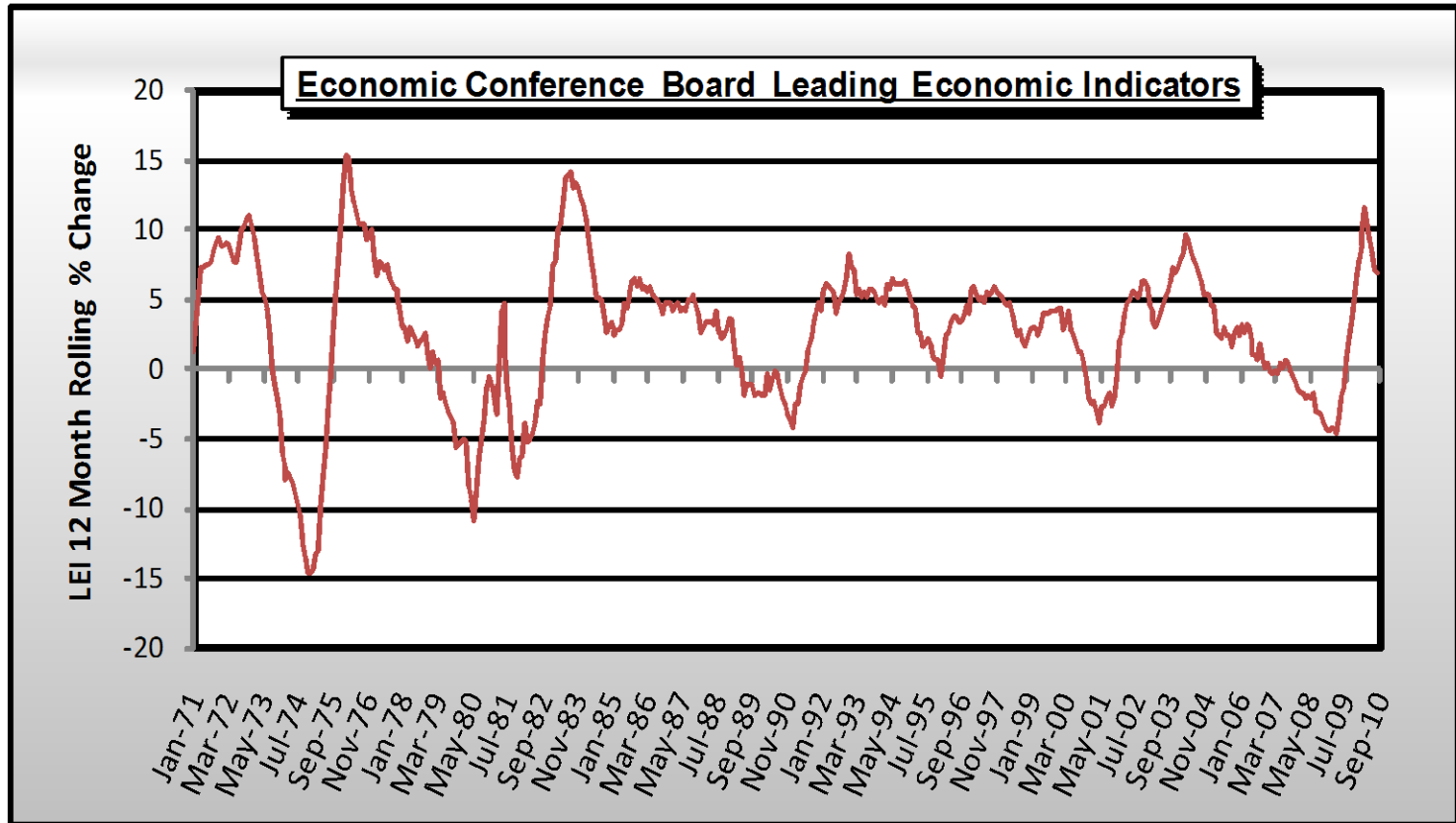
# Market Environment – U.S. Economy



**The Fed Balance Sheet continues to grow; however, the composition is evolving from stimulus and liquidity provisions to Treasury and mortgage-backed securities.**

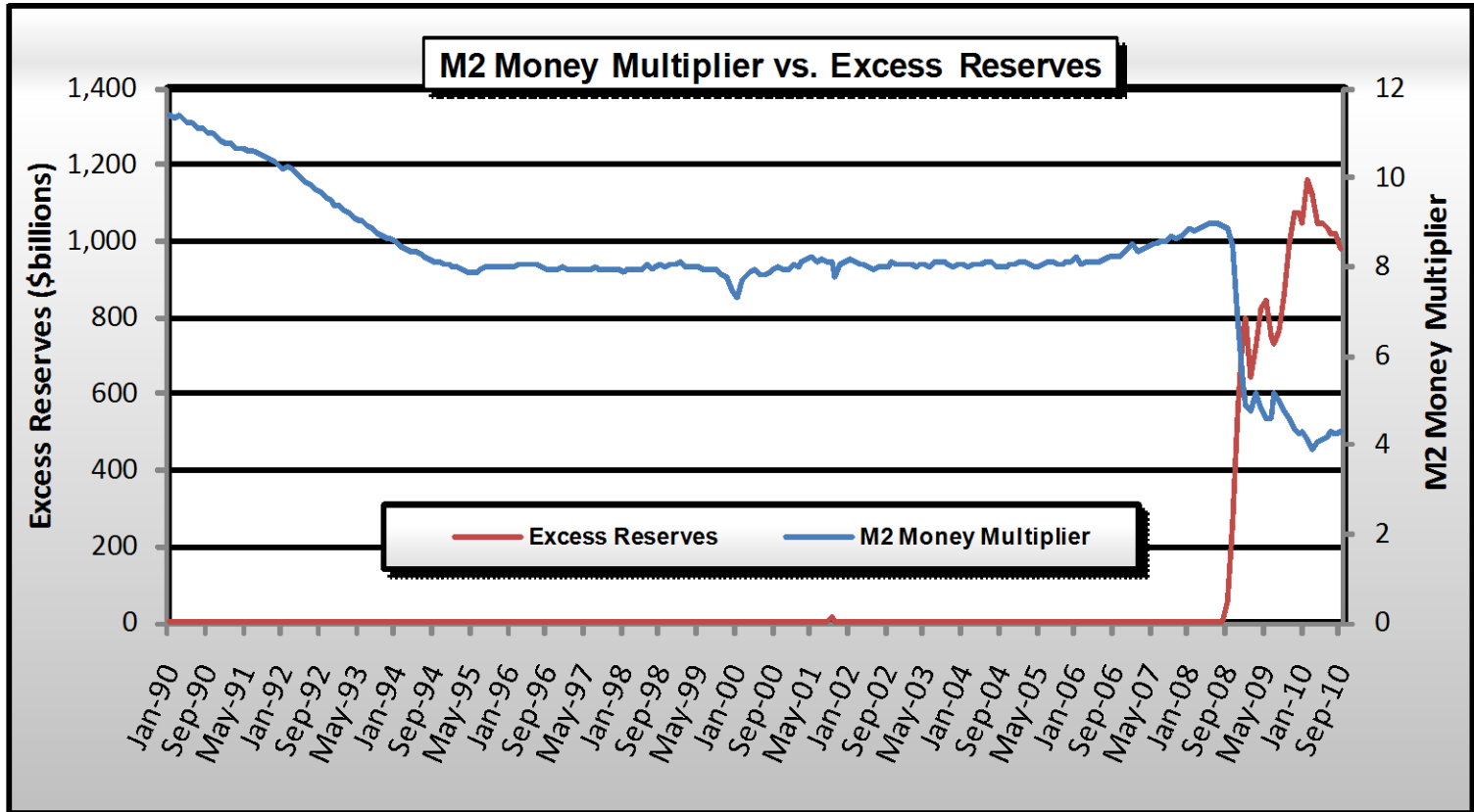


# Market Environment – U.S. Economy



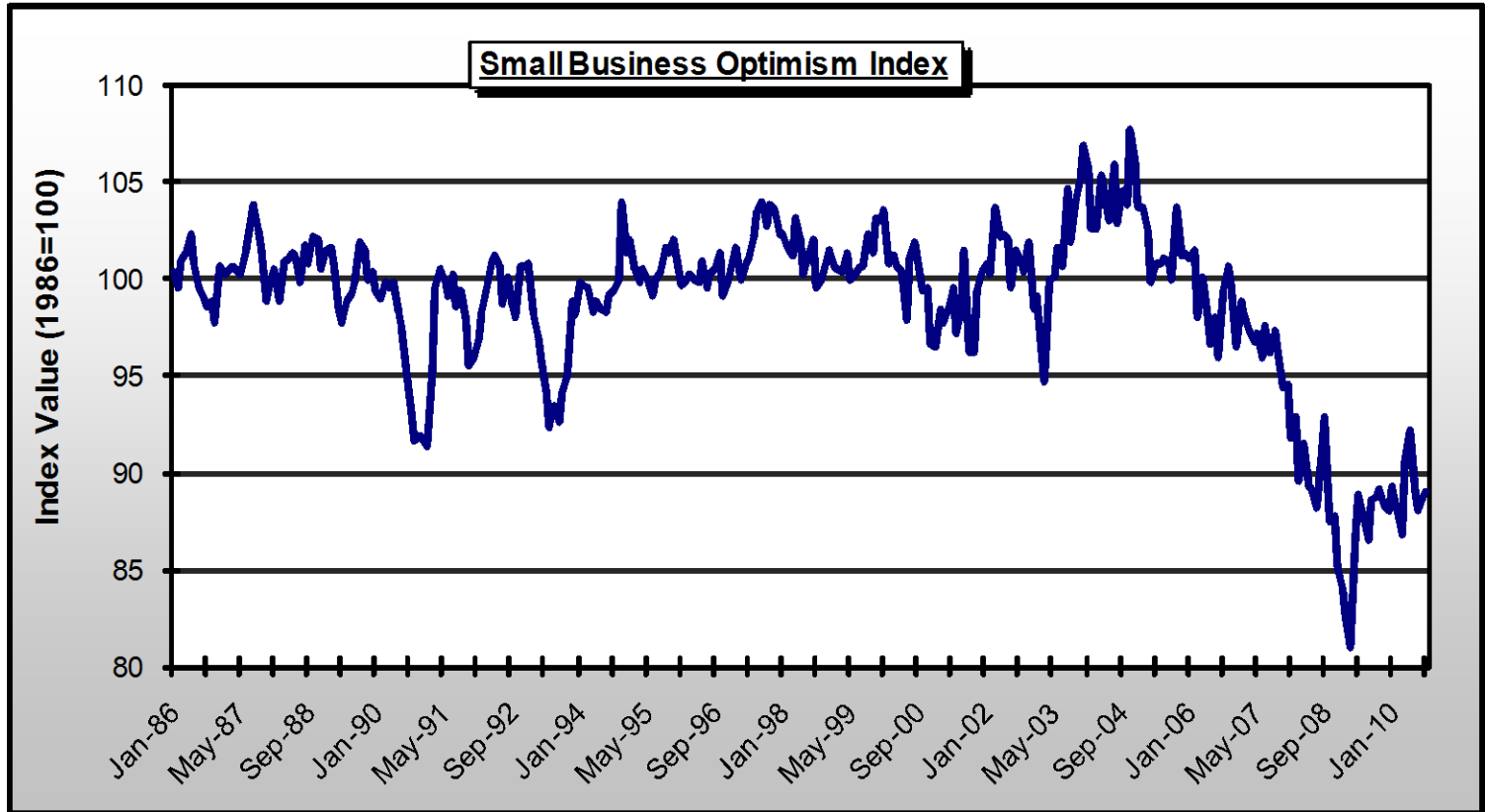
**Rolling percentage change in the Leading Economic Indicators index, while still positive, has begun trending downward.**

# Market Environment – U.S. Economy



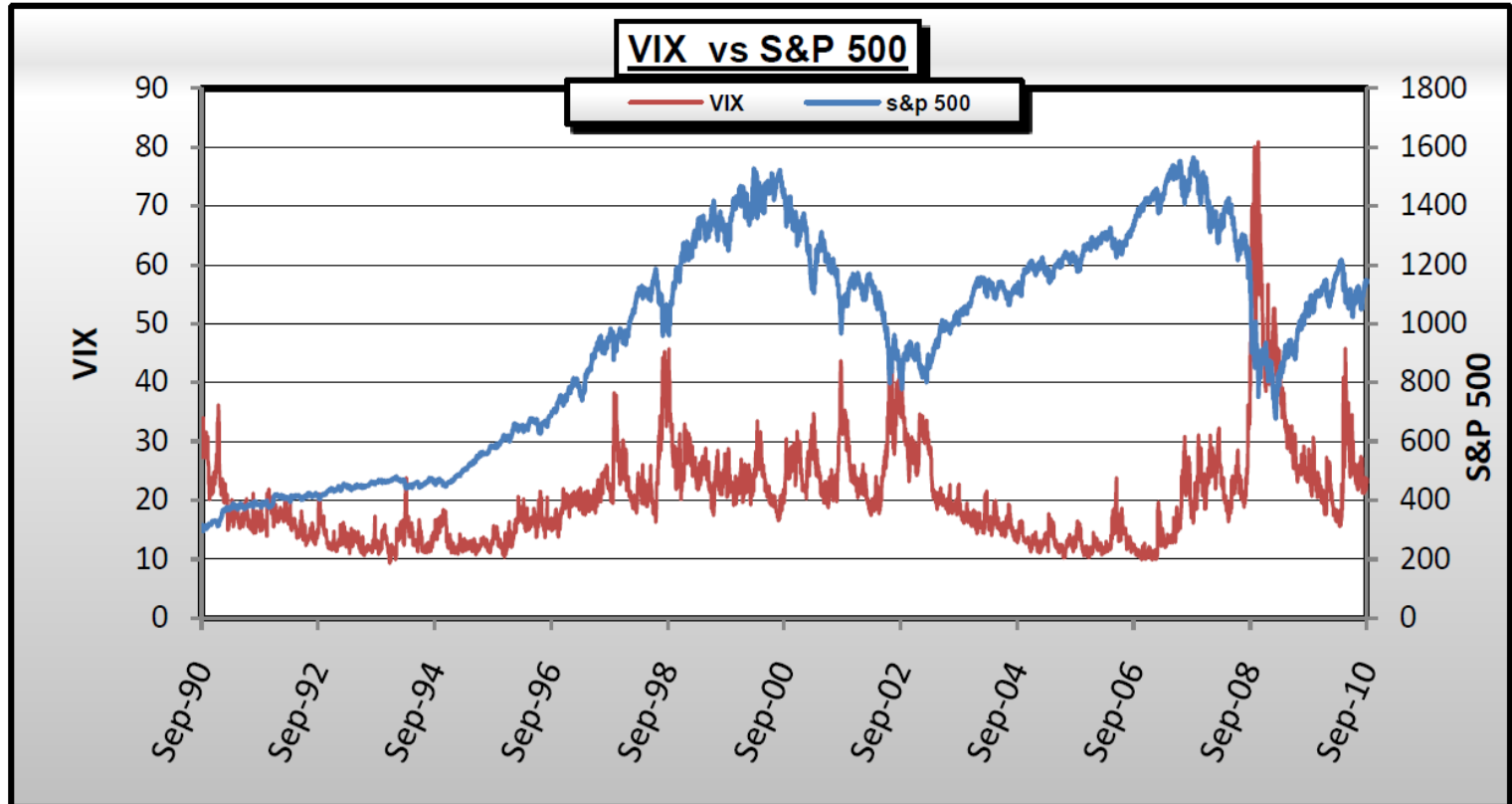
The impact of increased money supply has been muted (low money multiplier) as banks have kept unprecedented excess reserves.

# Market Environment – U.S. Economy



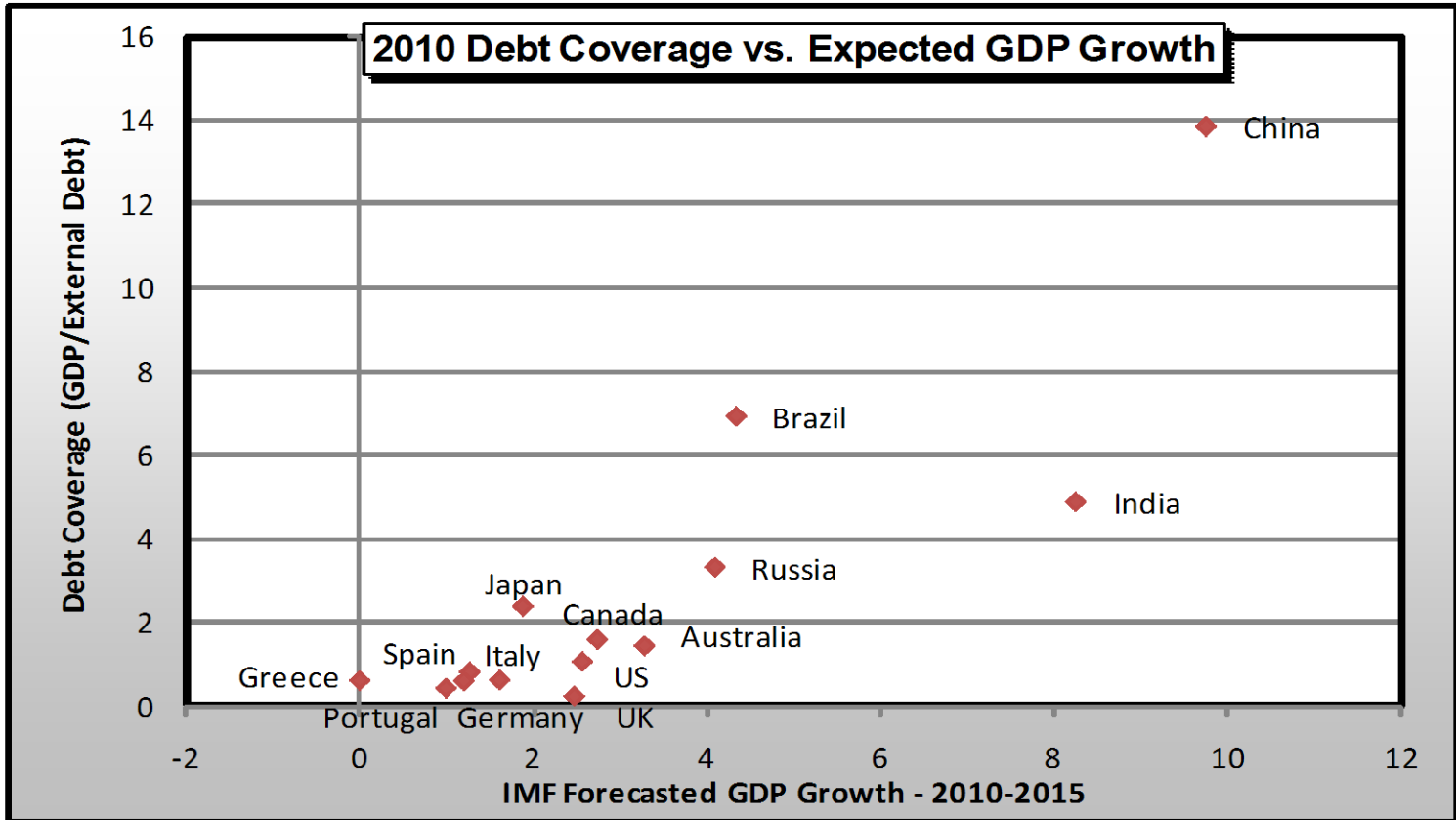
**The small business optimism index was flat in Q3, remaining at depressed levels.**

# Market Environment – U.S. Economy



The VIX retreated and equity markets rallied in Q3, despite a "risk on, risk off" market during the quarter.

# Market Environment – Global Economy



**Emerging Market countries have more robust growth expectations and more reasonable debt burdens.**

# Domestic & International Equities

- **The third quarter marked another volatile period for equity markets in which investor sentiment continued to drive returns.**
  - In July, the S&P 500 rebounded from the second quarter sell-off, retrenched in August amidst fears about a double-dip recession, then rallied late in the summer at the prospect of further monetary easing by the Fed to produce the strongest September performance since 1939 (+8.9%).
  - The S&P 500 returned 11.3% during the third quarter as all sectors posted positive returns during the period, with telecommunication services and cyclical sectors leading the way. Financials and Healthcare trailed due to uncertainty about the recovery of the real estate market and healthcare reform, respectively.
- **S&P 500 appears close to fairly valued based on cyclically-adjusted P/E ratios.**
- **Earnings yields continue to exceed 10-year bond yields.**
- **After turning negative early in the third quarter, S&P 500 momentum was poised to turn positive moving into October.**
- **Russell 2000 Index was up 11.3% during the third quarter.**
  - 12.5% return in September was best month ever for Russell 2000 and second best small cap month since 1939.
- **Domestic Small Cap stocks have outperformed Large Cap stocks by 4.7% year to date.**
- **Domestic Large Cap Value stocks have slightly outperformed Large Cap Growth stocks so far in 2010, while Small Cap Growth stocks are outperforming Small Cap Value stocks during the period.**
- **The S&P 500 has slightly outperformed International Equity (MSCI ACWI ex-U.S.) year to date (+0.2%), after a strong quarter for non-U.S. equities in both developed and emerging markets.**
  - Global stock markets participated in the broad based rally, receiving an additional tailwind from U.S. dollar weakness. Relative to local currency returns, the MSCI EAFE Index gained an additional 9.4% due to foreign currency gains against the U.S. dollar during the period.
  - Within the developed markets, Europe outperformed Asia as a weak Japanese market dragged the region down.
  - Emerging Markets led the way, posting an eye-popping 18% return during the third quarter.

# Fixed Income

- **Despite conflicting signals regarding the overall direction of the U.S. economy, most fixed income sectors posted positive returns for the quarter.**
  - Falling interest rates boosted returns across the fixed income markets as the Fed communicated the potential for additional monetary stimulus in the form of a second round of quantitative easing, as they continue to struggle with high unemployment, low inflation and weak domestic demand.
  - Quantitative easing has been priced into the market, but uncertainty remains in how much and in what the Fed will purchase.
- **Interest rates fell across the U.S. Treasury yield curve to near record lows, with the yield on the 10-year Treasury note falling 44 basis points to 2.53%.**
- **The Barclays Capital U.S. Aggregate Bond Index returned 2.5% in the third quarter, led by Long and Investment Grade Corporate Credit.**
  - During the quarter, most sectors outperformed Treasuries, with U.S. credit amongst the strongest performing segments of the bond market. The Barclays Capital U.S. Investment Grade Credit Index returned 4.7% during the quarter, while the Barclays Capital U.S. High Yield Index posted a 6.7% return.
  - Core fixed income is ahead of U.S. and non-U.S. equities year-to-date despite the strong quarter for equities.
- **“Reluctantly Bullish” on high yield for the next few quarters.**
  - Corporate debt levels are declining and leverage multiples are declining due to increases in EBITDA.
  - Strong new issuance, mostly refinancings.
- **High yield and emerging markets debt have been the strongest performing fixed income sectors year-to-date.**
  - Both corporate and sovereign credit sectors have performed well.
  - Weakening U.S. dollar vs. emerging market basket of currencies provided a tailwind to emerging market local currency debt.
- **Due to the current low growth environment in advanced economies, we continue to research opportunities in emerging countries, particularly in local currency bond markets.**

# Private Markets

- **Both private equity and real estate investment managers continue to be flexible and have allowed borrowers to amend-to-extend credit facilities, pushing maturities out to 2015 and later.**
  - Year-to-date through September 30, 2010, only 32 companies have defaulted on a total of \$12.9 B of debt, compared to all of 2009 when 106 companies defaulted on \$146.8 B of debt.
- **Credit markets currently favor borrowers, and many participated in the new issuance of both high yield and leveraged loans, and used the proceeds to refinance existing debt.**

	High Yield		Leveraged Loans	
	2009	2010	2009	2010
<b>New Issuances</b> (\$ in billions)	\$181.00	\$211.00	\$38.00	\$96.00
<b>New Issuances proceeds were used for:</b>				
<b>Refinancing</b>	76.0%	68.0%	42.3%	42.2%
<b>Acquisition LBO</b>	5.0%	15.0%	28.8%	37.2%
<b>Other</b>	19.0%	17.0%	28.9%	20.6%

- **Community and regional banks are under pressure from bankruptcies and real estate loans.**
  - Through October 15, 2010, 132 banks with \$86.0 billion in assets have failed. At this pace, failures should exceed the total amount of bank failures experienced in the period from 1993-2008 (153 bank failures).
- **The commercial property index remains 30-40% below peak values and significant equity value has been eliminated (many properties are only worth the outstanding debt).**
- **More than \$1.0 trillion of commercial real estate loans are coming due between now and 2014, and more than half of those loans are currently underwater.**
- **The volume of distressed/troubled real estate assets continues to grow and the % of sales that are “distressed” are rising as well.**
- **Given the macroeconomic issues globally, the amount of debt coming due and the projected impact of financial reform, we continue to emphasize opportunities in distressed, mezzanine and secondary strategies.**

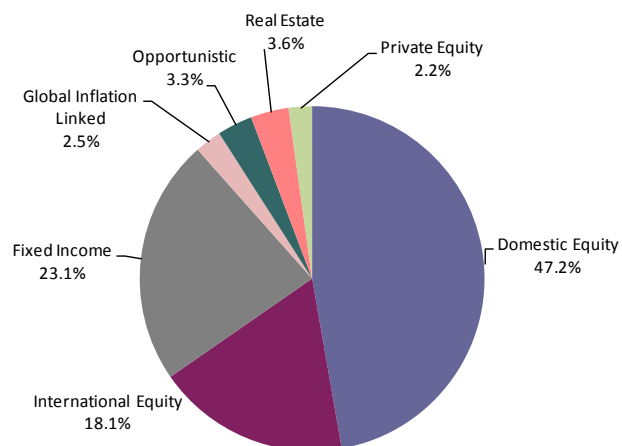


# ASRS Total Fund Review

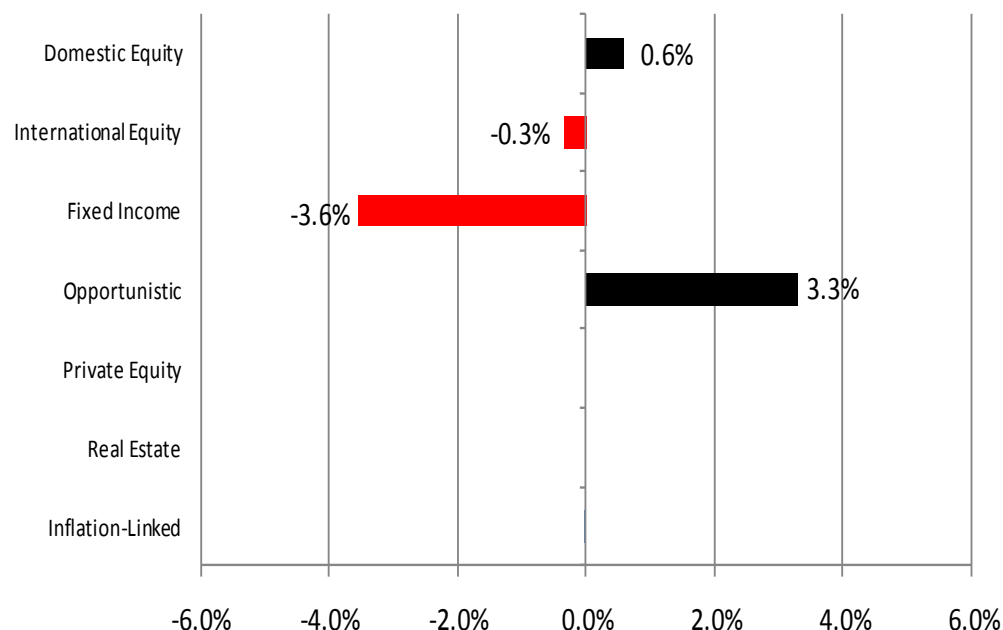
**Note: All of the data in this report is as of September 30, 2010, unless otherwise noted.**

# Total Fund Asset Allocation

**Actual Asset Allocation**



**Actual Asset Allocation vs. SAA Policy  
Adjusted for Transition into Real Estate,  
Private Equity and Inflation-Linked Assets\***




\*Real Estate, Private Equity and Inflation-Linked Assets actual weights are equal to policy weights during the implementation of these asset classes.

\*Over/Under- weights include both GTAA positions as well as IMD tactical considerations.

Note: Real Estate and Private Equity market values are reported on a quarter-lag and adjusted to include the current quarter's cash flows. Within the Policy Adjusted for Transition chart, Real Estate was prorated to domestic equity, international equity and fixed income, while Private Equity and Inflation-Linked Assets were prorated to domestic equity.

# Investment Program Investment Goals

- Macro
- 
- Goal #1: Achieve a total fund rate of return equal to or greater than the actuarial assumed interest rate.
  - Goal #2: Achieve a total fund rate of return equal to or greater than the strategic asset allocation policy.
  - Goal #3: Achieve a total fund rate of return equal to or greater than the amount projected in the most recent asset allocation study.
  - Goal #4: Achieve asset class net rates of return equal to or greater than their respective broad asset class benchmarks.
  - Goal #5: Achieve portfolio-level net rates of return equal to or greater than their respective portfolio benchmarks.
  - Goal #6: Ensure sufficient monies are available to meet cash flow requirements.
- Micro

## Total Fund Performance

- Goal #1: Achieve a total fund rate of return equal to or greater than the actuarial assumed interest rate.

	10 Year Annualized Return
Total Fund	3.2%
Constant 8%	8.0%
Excess Return	-4.8%

Goal Met: **No**

# Total Fund Performance

- Goal #2: Achieve annual and three-year rolling annual rates of return equal to or greater than the return of the Strategic Asset Allocation Policy (SAA Policy)

	Quarter	9 Months	1 Year	3 Years	5 Years	10 Years	Since Inception (6/30/75)
<b>Total Fund</b>	9.3%	6.4%	<b>10.8%</b>	<b>-2.4%</b>	3.3%	3.2%	9.8%
<b>Interim SAA Policy<sup>1</sup></b>	9.7%	6.3%	<b>10.2%</b>	<b>-2.3%</b>	3.6%	2.8%	9.7%
<b>Excess Return</b>	<b>-0.4%</b>	0.1%	<b>0.6%</b>	<b>-0.1%</b>	<b>-0.3%</b>	0.4%	0.1%

**1 Year Goal Met: Yes**  
**3 Year Goal Met: No**

<sup>1</sup>SAA Policy can be found on the last page of this presentation.

# Total Fund Attribution Analysis

<b>Total Plan</b>	<b>1 Year</b>	<b>3 Years</b>	<b>5 Years</b>
Allocation Effect <sup>1</sup> :	-0.17	-0.04	-0.02
Manager Selection Effect <sup>2</sup> :	0.72	0.11	-0.21
Residual <sup>3</sup> :	0.05	-0.17	-0.07
<b>Excess Return</b>	<b>0.60</b>	<b>-0.10</b>	<b>-0.30</b>

Source: State Street Investment Analytics

<sup>1</sup>Contribution due to over/underweights relative to Interim\* Strategic Asset Allocation Policy.

<sup>2</sup>Contribution due to manager selection (net) and interaction effect.

<sup>3</sup>Contribution due to activities not captured in Allocation and Manager Selection Effects.

\*Pro-rates unfunded Real Estate, Private Equity and Commodities allocations



# Total Fund Attribution Summary

## **1 Year Excess Return: 0.6%**

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- Manager Selection Effect: 0.72%
  - Fixed Income outperformed due to F2 and BGI (0.30%)
  - GTAA outperformed due to Bridgewater (0.16%)
  - Large Cap Equity outperformed due to LSV, Jacobs Levy and E portfolios (0.22%)
- Allocation Effect: -0.17%
  - Fixed Income tactical underweight (-0.30%)
  - Opportunistic effects (0.18%)
- Residual Effect: 0.05%

## **3 Years Excess Return: -0.1%**

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- Manager Selection Effect: 0.11%
  - Fixed Income outperformed due to F2 and BGI (0.15%)
  - Large Cap Equity outperformed due to LSV, INTECH and E portfolios (0.21%)
  - Real Estate underperformed due to various managers (-0.26%)
- Allocation Effect: -0.04%
  - Fixed Income tactical underweight (-0.33%)
  - Large Cap Equity tactical overweight (0.18%)
  - Opportunistic effects (0.12%)
- Residual Effect: -0.17%

## **5 Years Excess Return: -0.3%**

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- Manager Selection Effect: -0.21%
  - International Equity underperformed due to Brandes (-0.20%)
  - Real Estate underperformed due to various managers (-0.11%)
  - Fixed Income outperformed due to F2 and BGI (0.07%)
- Allocation Effect: -0.02%
  - Large Cap Equity tactical weightings (0.06%)
  - Mid Cap Equity tactical weightings (-0.04%)
- Residual Effect: -0.07%

## Total Fund Performance

- Goal #3: Achieve a five-year rolling annual rate of return equal to or greater than the projected return expectation in the ASRS Asset Allocation Study.

	<u>5 Year Annualized Return</u>
Total Fund	3.3%
AA Expected Return	<u>8.2%</u>
Excess Return	<b>-4.9%</b>

Goal Met: **No**



# Asset Class Performance vs. Benchmark

- Goal #4: Achieve annual and three-year rolling annual investment asset class net rates of return equal to or greater than their respective broad asset class

	1 Year Return	3 Year Return
ASRS Domestic Equity	12.6%	-5.2%
Domestic Benchmark <sup>1</sup>	11.7%	-6.0%
Excess Return	0.9%	0.8%
ASRS Int'l Equity	6.8%	-7.1%
MSCI ACWI ex U.S.	8.0%	-7.0%
Excess Return	-1.2%	-0.1%
ASRS Fixed Income	9.1%	8.0%
BC Aggregate	8.2%	7.4%
Excess Return	0.9%	0.6%
ASRS GTAA	14.4%	0.3%
Custom Benchmark <sup>2</sup>	9.0%	-3.1%
Excess Return	5.4%	3.4%
ASRS Real Estate	1.0%	-15.7%
NPI + 1%	-0.5%	-3.8%
Excess Return	1.5%	-12.0%
ASRS Private Equity	14.2%	n/a
Russell 3000 + 300 bps	19.2%	-6.7%
Excess Return	-5.0%	n/a
ASRS Opportunistic <sup>3</sup>	29.7%	n/a

**Goal Met: Partially**

<sup>1</sup>Domestic Equity Benchmark was S&P 500 through 12/31/2006 and 74% S&P 500, 13% S&P 400, 13% S&P 600 thereafter.

<sup>2</sup>GTAA Custom Benchmark is 56% S&P 500, 16% MSCI EAFE, 28% Barclays Capital Aggregate.

<sup>3</sup>Net absolute rate of return expectations range from 10-14% per annum.

## Manager Performance vs. Benchmarks

- Goal #5: Achieve annual and three-year rolling annual portfolio level net rates of return equal to or greater than their respective policy benchmarks.

	1 Year	3 Years
Outperformers #	39	19
Underperformers #	55	17
Outperformers%	41.5%	52.8%

**1 Year Goal Met: No**  
**3 Year Goal Met: Yes**

Note: Includes both public and private markets investment managers.

# Cash Management

- Goal #6: Ensure all pension benefits, health insurance, member refunds, administrative payments and other requirements are made from available cash balances and without utilizing alternative liquidity options.

Month	Master Cash Balance pre-run	Net Pension Run	Master Cash Balance post-run
Nov-09	\$164,395,519	(\$150,385,154)	\$23,388,095
Dec-09	\$192,641,724	(\$149,726,736)	\$53,256,380
Jan-10	\$191,061,998	(\$150,004,874)	\$47,206,171
Feb-10	\$161,224,140	(\$151,074,678)	\$21,569,784
Mar-10	\$176,986,852	(\$151,897,969)	\$26,540,315
Apr-10	\$220,056,521	(\$152,698,575)	\$101,148,397
May-10	\$240,698,047	(\$152,380,236)	\$96,924,980
Jun-10	\$178,753,811	(\$152,930,630)	\$26,483,778
Jul-10	\$93,815,370	(\$156,329,556)	\$29,421,495
Aug-10	\$270,163,586	(\$159,316,955)	\$101,638,002
Sep-10	\$165,691,137	(\$160,397,420)	\$16,874,577

**All Pension Obligations, Capital Calls and Other  
Requirements Met with Available Cash**

**Goal Met: Yes**

# Total Fund Performance Comparison\*

<b>Independent Consultant's Cooperative</b>	<b>1 Year</b>	<b>3 Years</b>	<b>5 Years</b>	<b>10 Years</b>
Master Trust Funds - Total Funds	33	68	58	77
Total Funds - Public Funds	30	62	54	81
Total Funds over \$1 B - Public	37	40	51	77
Total Funds - Corporate	39	73	64	78

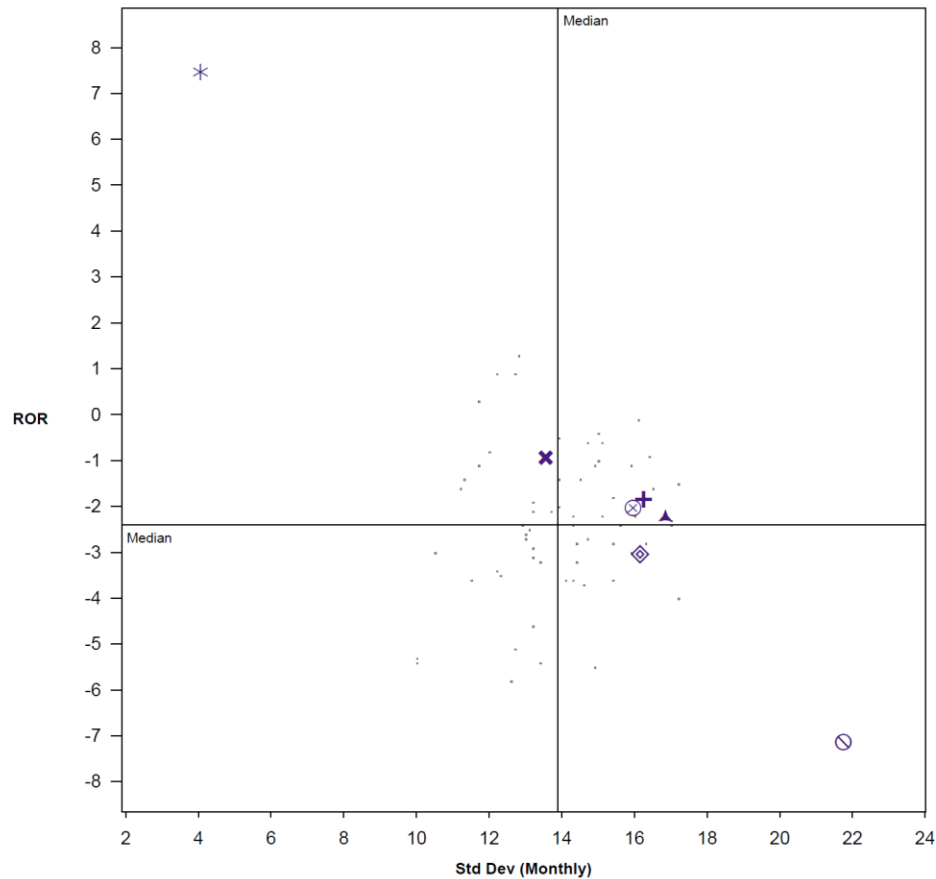
<b>Callan Associates Inc.</b>	<b>1 Year</b>	<b>3 Years</b>	<b>5 Years</b>	<b>10 Years</b>
Master Trust Funds - Total Funds	28	55	57	74
Total Funds - Public Funds	22	53	50	80
Total Funds over \$1 B - Public	30	46	54	85
Total Funds - Corporate	38	63	68	73

\*The information contained herein is for comparison purposes only and is not a Total Fund performance benchmark. Peer universe comparisons are subject to several limitations, including: peer groups are not comprehensive, several funds are included in multiple peer groups, peer groups are constructed using gross of fees returns and survivorship bias in that poorly performing funds may no longer continue to report results.

Note: Universes are constructed using gross of fee returns; therefore, the ASRS rank is based on gross of fee returns.



# 3 Yr. Return/Volatility vs. Public Funds > \$ 1 Billion



NAME	Return		Standard Deviation		Sharpe Ratio	
⊗ TOTAL FUND	-2.1	40	16.0	86	-0.2	40
◇ ACTUAL BENCHMARK	-3.1	74	16.2	89	-0.3	61
▲ INTERIM SAA POLICY	-2.3	48	16.9	94	-0.2	41
+ SAA POLICY	-1.9	37	16.3	89	-0.2	38
⊙ S&P 500	-7.2		21.8		-0.4	
* BC AGGREGATE	7.4		4.1		1.5	
✕ 60% S&P 500/40% BARCLAYS AGG	-1.0		13.6		-0.2	
Median	-2.4		13.9		-0.2	

\*Interim Benchmark (current): 35% S&P 500, 7% S&P 400, 7% S&P 600, 19% MSCI ACWI ex-U.S., 27% Barclays Capital Aggregate, 4% NCREIF Property Index + 100 bps (lagged one quarter), and 1% Russell 3000 + 300 bps.

Note: Interim Benchmark incorporates a proration of 2% Real Estate and 6% Private Equity

Returns are Gross of Fees.

# **Investment Outlook**

# Third Quarter 2010 NEPC Observations and Opportunities

- **Markets experienced roller-coaster of a quarter – July up, August down, September up – as global themes continued to dominate**
  - Overall, strongly positive period for risky assets
- **Forward looking return expectations are declining, as possibilities of extreme environments remain elevated**
  - Maintain risk balanced portfolios to protect against continued deleveraging and/or future inflation
  - Seek opportunities for excess return where available
  - Consider role of alpha-oriented strategies in low expected-return environment, particularly flexible approaches such as global asset allocation and global macro
- **Emerging markets are attractive as structural debt issues stifle developed world growth**
  - Opportunities to benefit from consumer-led growth in smaller company stocks
  - Emerging currencies are attractive and remain poised for long term appreciation relative to US dollar and other developed currencies
- **Illiquid credit opportunities remain attractive even as liquid credit markets continued to perform in the 3<sup>rd</sup> quarter**
  - Liquidity-provision strategies are uniquely positioned to do well in current environment
  - Distressed debt and real estate represent a longer term opportunity given structural issues

# What Happened and What IMD Did During Q3 2010

## What Happened

- Asset classes displayed mixed results throughout Q3
  - Fixed income spreads tightened leading to a strong rally in all credit markets
  - Both U.S. and non-U.S. equities experienced strong positive returns
  - Strongly performing U.S. equities trailed non-U.S. equities
- Dollar weakness throughout Q3 was a major contributor to non-U.S. relative performance
- Actual Q3 S&P corporate earnings exceeded estimates; earnings of non-U.S. companies were equally strong
- U.S. unemployment rate continues to hover near 10%
- The price of gold displayed early weakness in Q3, then rebounded sharply

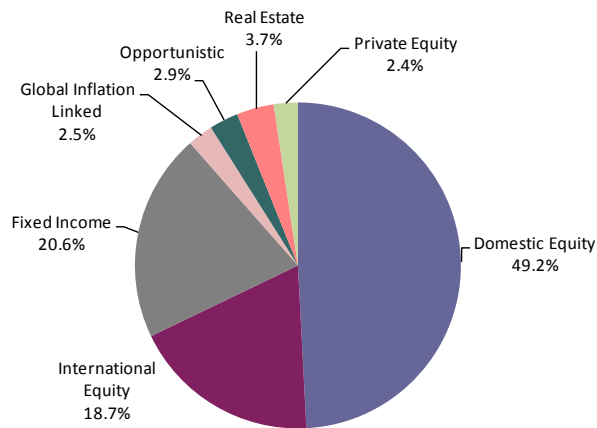
## IMD Activities

- Continued to implement allocations to asset classes and rebalancing
- Additions
  - Funded 2 Commodities mandates
  - Funded 1 passive Emerging Markets Equities mandate
  - Selected 3 Emerging Markets Equities managers
- Terminations
  - 1 Opportunistic manager
  - 1 passive Non-U.S. Equity mandate
- Tactically reduced exposure to U.S. Mid Cap Equities
- Tactically increased exposure to High Yield Fixed Income

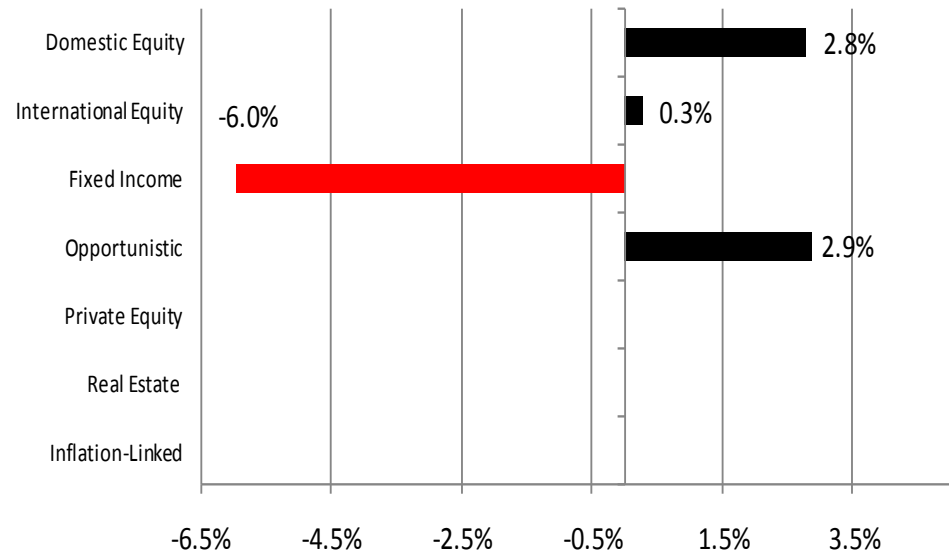


# Where Are We Now? (as of November 29, 2010)

## Actual Asset Allocation



## Actual Asset Allocation vs. SAA Policy Adjusted for Transition into Real Estate, Private Equity and Inflation-Linked Assets\*



\*Real Estate, Private Equity and Inflation-Linked Assets actual weights are equal to policy weights during the implementation of these asset classes.

\*Over/Under- weights include both GTAA positions as well as IMD tactical considerations.

# IMD Investment House Views

- **Fixed Income**

- The potential for attractive returns from the fixed income markets going forward has meaningfully diminished due to a combination of significantly lower interest rates and significant spread tightening this past year.
- The absolute low level of yields limits potential returns. At current levels, select credit markets such as high yield bonds and securitized credit should continue to provide attractive returns and should outperform core.

- **US Equities**

- Anxiety over sovereign debt interrupted the market advance that had been in place since August.
- Near-term, prices of both the mid-cap and small-cap market sectors are slightly ahead of strong underlying fundamentals and may be due for modest pull-backs before advancing further.
- Prices are less extended for the large-caps. Nevertheless, current monetary policy is supportive of higher asset prices, particularly equities.
- IMD reduced its moderate tactical bias in U.S. Equities relative to Non-U.S. Equities and to the overall fund. The residual bias is being held in reserve for eventual additional funding of the commodities asset class.

- **International Equities**

- IMD reduced its under-weight to Non-U.S. Equities to approximate parity with the SAA policy as it completes restructuring of the asset class.
- Additional restructuring within the Non-U.S. Equities class funded the new Emerging Markets sub-class.
- IMD continues to favor an active strategic allocation to Emerging Markets and less active exposure to developed Non-U.S. Equities.

# IMD Investment House Views

- **Private Equity**

- Private Equity continues to favor managers with proven investment processes and top quartile returns who manage funds that target companies with enterprise values in the small, lower middle and middle markets.
- These segments of the market appear to represent the largest opportunity set for portfolio company acquisitions, which historically have been underserved, employed lower levels of leverage, focused on operational enhancements to add value and achieved lower purchase price multiples.
- IMD will continue focusing on opportunities within secondaries, energy, clean tech, acquisitions of secondary interests, co-investments, focused infrastructure opportunities and in distressed-for-control, turnaround and mezzanine funds.

- **Real Estate**

- Real estate may be nearing an inflection point, where valuations look to be bottoming and in the case of core well located assets, even increasing in price. Yet fundamentals are still a mixed bag with apartments and hotels seeing some improvement in fundamentals while office, industrial and retail still are struggling.
- The CMBS market appears ready to show some life in 2011 and distressed debt investing may be the next great opportunity due to the financing gap from over \$1 trillion dollars of debt maturing over the next three at high LTV ratios that will not be refinanced by lenders today at those levels.
- A review and potential modification of the Real Estate Strategic Plan and 2011 Implementation Plan is ongoing.

- **Opportunistic**

- IMD believes opportunities continue to exist in select fixed income markets with such tactical investments made primarily through ASRS opportunistic fixed income investment managers.
- IMD has reduced some exposure in CMBS and RMBS through the defunding of a manager following a rapid recent price appreciation in these sectors.

# Appendix

# Strategic Asset Allocation (SAA) Policy History

- 7/1/75 – 12/31/79 – 40% S&P 500/60% Barclays Capital Aggregate
- 1/1/80 – 12/31/83 – 50% S&P 500/50% Barclays Capital Aggregate
- 1/1/84 – 12/31/91 – 60% S&P 500/40% Barclays Capital Aggregate
- 1/1/92 – 12/31/94 – 50% S&P 500/40% Barclays Capital Aggregate/10% MSCI EAFE
- 1/1/95 – 6/30/97 – 45% S&P 500/40% Barclays Capital Aggregate/15% MSCI EAFE
- 7/1/97 – 12/31/99 – 50% S&P 500/35% Barclays Capital Aggregate/15% MSCI EAFE
- 1/1/00 – 9/30/03 – 53% S&P 500/30% Barclays Capital Aggregate/17% MSCI EAFE
- 10/1/03 – 12/31/06 – 53% S&P 500/26% Barclays Capital Aggregate/15% MSCI EAFE/ACWI ex-U.S.<sup>1</sup>/6% NCREIF Property Index + 100 bps (lagged one quarter)
- 1/1/07 – 10/31/2009 – 31% S&P 500/7% S&P 400/7% S&P 600/26% Barclays Capital Aggregate/18% MSCI ACWI ex-U.S./6% NCREIF Property Index + 100 bps (lagged one quarter)/5% Russell 3000 + 300 bps
- 11/1/2009 – present – 28% S&P 500/6% S&P 400/6% S&P 600/24% Barclays Capital Aggregate/2% Barclays Capital High Yield/13% MSCI EAFE/2% MSCI EAFE Small Cap/3% MSCI Emerging Markets/6% NCREIF Property Index + 100 bps (lagged one quarter)/7% Russell 3000 + 300 bps/3% Dow Jones/UBS Commodities Index
- \*Interim SAA Policy: 35% S&P 500, 7% S&P 400, 7% S&P 600, 19% MSCI ACWI ex-U.S., 27% Barclays Capital Aggregate, 4% NCREIF Property Index + 100 bps (lagged one quarter), and 1% Russell 3000 + 300 bps
- Note: Interim SAA Policy includes a proration of 2% Real Estate, 6% Private Equity, and 3% Inflation-Linked, which are unfunded. 9% of the proration is allocated to domestic equity, 1% to non-U.S. equity and 1% to fixed income.

<sup>1</sup>MSCI EAFE/ACWI ex-U.S. Benchmark is the MSCI EAFE Index prior to 10/1/2005 and the MSCI ACWI ex-U.S. thereafter